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SUBJECT: IS TAIWAN FAVORING EXCHANGE RATE STABILITY OVER
FREE CAPITAL FLOWS?

Classified By: AIT Director Stephen M. Young for reasons 1.5 (b), (c)

11. (C) SUMMARY. In recent years, the New Taiwan Dollar (NT) has been one of the weakest performers in Asia vis-a-vis the U.S. dollar, and capital outflows for portfolio investment have increased dramatically. Taiwan's central bank appears to have adopted an informal policy to bolster the NT by discouraging capital outflows and encouraging domestic investment. Central bank officials insist they are not swerving from a long term commitment to open fund flows. Some Taiwan officials, however, acknowledge the bank has been taking short term measures to discourage capital outflows and encourage domestic portfolio investment. Contacts in local and U.S. financial firms also see indications of these measures. It is not clear how long the current emphasis on domestic investment will last. END SUMMARY.

Weak NT\$ and Surge of Capital Outflows

12. (U) Unlike many currencies in the region, Taiwan's currency has failed to appreciate significantly against the greenback. In the past two years, for example, the New Taiwan Dollar has appreciated less than two percent against the US Dollar, while both the Singapore Dollar and the Korean Won have appreciated more than 14%. China's Renminbi has appreciated about 8%. (The Japanese Yen, another laggard, actually depreciated about two percent against the US Dollar.)

13. (U) At the same time, Taiwan has seen a surge in capital outflows for portfolio investment. From the years 2002 to 2005, annual net capital outflows ranged from a high of US\$8.8 billion in 2002 to a low of US\$2.9 billion in 2005. In 2006, however, these outflows increased dramatically to US\$20 billion, and accelerated to US\$11.7 billion in the first quarter of 2007 alone. The number dropped to US\$7.1 billion for the second quarter, but that was still higher than the same period last year.

Is the Central Bank Trying to Stem the Outflows?

14. (SBU) In a recent meeting with econoff, a major U.S.

mutual fund company expressed concern that over the past several months Taiwan authorities appear to have adopted a policy of discouraging capital outflows through "guidelines" and other quasi-formal measures. The policy measures seem to have originated at Taiwan's central bank but have been relayed through financial regulators and industry groupings.

Smoking Gun or Just Smoke?

15. (U) In May, Taiwan authorities sent a clear message to the fund industry and the general public encouraging more domestic portfolio investment. Senior officials from the central bank and the Financial Services Commission (FSC) met with executives from a group of investment trust companies. In a press release issued after the meeting, the central bank publicly urged investment firms to fully disclose the risks involved in foreign investments and quoted a private research report that Taiwan stocks were significantly undervalued. "It is not difficult to see that Taiwan's stocks are relatively cheap and local institutional investors have allotted a disproportionately small percentage of their portfolios to domestic equity," stated the press release.

16. (C) Some U.S. asset management firms believe that the central bank is doing more than just issuing press releases. They claim that the central bank is devoting an extraordinarily high level of scrutiny to their fund applications and business activities. In a recent conversation with econoff, Terrance Hui, who heads the Taiwan subsidiary of U.S. investment firm Invesco, stated that the Taiwan authorities do appear to be delaying overseas mutual fund approvals as part of a broader strategy to support domestic investment, but added that the issue has not been a

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major problem for his firm. (Note: The local fund industry group told econoff that they saw no indication of delays in fund approvals for domestic or overseas funds. End Note)

17. (C) FSC officials have also alluded to a shift in policy, if only temporary. In a September 28 meeting with visiting U.S. Treasury officials, Susan Chang, Vice Chairman of the Financial Supervisory Commission (FSC), Taiwan's bank regulator, noted that capital outflows "needed to be watched closely." A few weeks earlier, in a meeting with AIT/W Director of Trade and Commercial Programs Rick Ruzicka, FSC Chairman Dr. Hu Sheng-Cheng was a bit more forward, explaining that Taiwan's long term policy in support of free capital flows has not changed, but that Taiwan's central bank has adopted "short term" measures to encourage domestic investment and discourage outflows. According to Hu, the policy is based solely on maintaining exchange rate stability.

18. (C) A Taipei-based senior U.S. mutual fund company executive cites conversations with senior financial officials in asserting that the policy shift is motivated in part by political concerns. In this analysis, the Chen government is seeking to encourage domestic investment as a means of propping up the stock market and showcasing its economic stewardship.

19. (C) Victor Kung, President of Fubon Financial Holding Co., Taiwan's third-largest financial institution, also told us the authorities appear to be encouraging domestic investment. Kung expressed underlying confidence in the independence of the Central Bank, and attributed the policy to a focus on exchange rate stability, rather than political motivations. The emphasis on stability jibes with what we heard from senior central bank officials during a recent case involving an overseas fund transfer in excess of US\$ 500 million by a U.S. firm's Taiwan subsidiary. Although regulations do not place restrictions on the amount of overseas fund flows, in practice the bank asked the firm to stagger the transfer over a period of days in order to avoid potential exchange rate disruptions.

Central Bank Denies Policy Shift

¶10. (SBU) During informal conversations with AIT staff, central bank officials have denied any change in underlying policy on overseas fund transfers, instead stressing that their role is limited to maintaining exchange rate stability in the relatively small market for the NT dollar. This message was reiterated on October 1 in a question and answer session with legislators, when Bank Governor Peng Fai-nan affirmed that the bank would not interfere in the foreign exchange market or obstruct capital flows. He further offered that the bank's recent rate rise was to address concerns about inflationary pressures in Taiwan, not to attract foreign funds and would have no effect on stock prices.

Rosy Outlook - Problem Solved?

¶11. (C) On September 28 George Chou, deputy governor of the central bank, told visiting U.S. Treasury officials capital outflows were particularly pronounced from May to August, a period for which figures have not yet been publicly released. He speculated, however, that outflows will drop. He pointed to the bank's September 20 rate hike of 125 basis points and implied that another rate hike was likely, thus narrowing the difference between U.S. and Taiwan rates. He also anticipates an improving domestic stock market, which he predicted would rise in the run-up to the presidential election next March. Both narrowing interest rate spreads and a rising domestic stock market should stem the net outflow, he said.

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¶12. (SBU) COMMENT. Evidence that fund flow policy is driven by political concerns is anecdotal, difficult to prove, and is flatly denied by senior central bank officials. We believe, however, that there has been at least a temporary shift toward discouraging overseas fund outflows. How long it lasts, or whether it has already ended, is not clear. Perhaps due to various motivating factors behind the policy, the new emphasis on domestic investment does not appear to have been communicated effectively to the financial sector, and has increased the level of policy uncertainty. We will continue to encourage our Taiwan counterparts to maintain regulatory transparency and implement a liberal financial transfer regime. We will also work closely with Amcham which, due to industry interest, has established an asset management committee to follow the issue and lobby for a more liberal regulatory environment. END COMMENT.
YOUNG